Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Allen	Analyst:	Brian Werking	Bill Number:	AB 1196
Related Bills:	See Legislative History	Telephone:	845-5103	Amended Date:	May 10, 2011
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Earned Income Credit/Additional 0.7 Percent Personal Income Tax Rate Increase For Taxable Income Over $1,000,000 Beginning January 1, 2012

SUMMARY

This bill would impose an additional 0.7 percent Personal Income Tax on taxable income over $1,000,000 and would create a refundable earned income credit (EIC) equal to 15 percent of the federal EIC.

RECOMMENDATION AND SUPPORTING ARGUMENTS

No position.

Summary of Amendments

The bill as amended May 10, 2011, would add two provisions related to a refundable state income tax credit. The first provision would impose an additional 0.7 percent Personal Income Tax (PIT) on taxable income over $1,000,000. The second provision would create a refundable EIC equal to 15 percent of the federal EIC, which would be funded by the additional tax imposed by the first provision. As a result of the amendments, the department's analysis of the bill as amended March 31, 2011, no longer applies.

PURPOSE OF THE BILL

It appears the purpose of this bill is to encourage employment and provide tax relief and financial support to low-income taxpayers.

EFFECTIVE/OPERATIVE DATE

This bill would be effective on January 1, 2012, and specifically operative for taxable years beginning on or after January 1, 2012.

Board Position:			Executive Officer	Date
_______ S	_______ NA	___X___ NP		
_______ SA	_______ O	_______ NAR	Selvi Stanislaus	05/25/11
_______ N	_______ OUA			

SUMMARY OF REVENUE IMPACT

This bill would result in the following revenue gains:

Estimated Revenue Impact of AB 1196 For Taxable Years Beginning On or After January 1, 2012 Enactment Assumed After June 30, 2011 ($ in Millions)			
	2011-12	2012-13	2013-14
Refundable Earned Income Credit	-$420	-$750	-$750
Additional 0.7% Tax On Income Over $1M	+$490	+$800	+$850
Total Revenue Impact	+$70	+$50	+$100

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill.

SUPPORT/OPPOSITION

Support: None provided.

Opposition: The California Taxpayers Association[1].

ARGUMENTS

Pro: Some taxpayers may argue that during these difficult economic times it is important to encourage employment, provide tax relief, and provide financial support to California's low-income taxpayers.

Con: Some taxpayers may argue that this bill fails to encourage employment and with the state's current fiscal crisis, additional tax expenditures should be avoided.

PROVISION 1-TAX RATE INCREASE

ANALYSIS

FEDERAL/STATE LAW

Federal tax law imposes six different income tax rates on individuals, estates, and trusts ranging from 10 percent to 35 percent.

State tax law, for taxable years beginning on or after January 1, 2011, imposes six different rates under the Personal Income Tax Law (PITL) ranging from 1 percent to 9.3 percent. For taxable years beginning on or after January 1, 2009, and before January 1, 2011, each of the six tax rate percentages was increased by an additional 0.25 percent. Each tax rate applies to different ranges of income, known as "tax brackets."

[1] As provided in the Assembly Committee on Appropriations' analysis of the bill as amended May 10, 2011, available at: http://www.leginfo.ca.gov/pub/11-12/bill/asm/ab_1151-1200/ab_1196_cfa_20110517_124421_asm_comm.html

Current state tax law requires the Franchise Tax Board (FTB) to recalculate the tax brackets each year based on the change in the California Consumer Price Index (CCPI).

State tax law imposes separate income tax brackets for individuals filing as head of household and other individuals. Tax rates for individuals filing as head of household are imposed at a higher income bracket than those same rates imposed on individuals not filing as head of household. For example, for the 2010 taxable year, an individual filing as single or married/registered domestic partner filing separately is subject to a 9.55 percent tax rate for taxable income over $46,766; an individual filing as head of household is subject to 9.55 percent tax rate for taxable income over $63,657.

State tax law uses the tax brackets for individuals not filing as head of household to determine the tax rate for married individuals/registered domestic partners filing jointly. The joint taxable income of married couples/registered domestic partnerships filing jointly is halved and then applied to the appropriate individual tax bracket to determine the tax rate. The appropriate tax rates are applied to half of the joint income, and the resulting amount is doubled to determine the tax due for married couples/registered domestic partnerships filing jointly.

State tax law imposes an additional 1 percent mental health services tax (MHST) on taxable income in excess of $1,000,000. This tax may not be reduced by the application of tax credits. This tax is applied equally to the taxable income of individuals, individuals filing as head of household, individual income of married individuals/registered domestic partners filing separately, and the joint income of married individuals/registered domestic partners filing a joint return. The $1,000,000 tax bracket is not subject to indexing for inflation.

THIS PROVISION

This provision would impose a 0.7 percent PIT in addition to the current 1 percent MHST on taxable income in excess of $1,000,000 for taxable years beginning on or after January 1, 2012. This tax would not be reduced by the application of tax credits. This tax would apply equally to the taxable income of individuals, individuals filing as head of household, individual income of married individuals/registered domestic partners filing separately, and the joint income of married individuals/registered domestic partners filing a joint return. The $1,000,000 tax bracket would not be subject to indexing for inflation.

This provision would establish the Earned Income Tax Credit Fund (Fund). All revenues, less refunds, derived from the imposition of the 0.7 percent tax would be deposited into the Fund. The proceeds of this Fund would be continuously appropriated to the FTB to provide for refunds as a result of the refundable state EIC.[2]

IMPLEMENTATION CONSIDERATIONS

Implementing this provision would require some changes to existing tax forms and instructions and information systems, which could be accomplished during the normal annual update.

[2] Provision 2 of this bill would establish a refundable state EIC.

LEGISLATIVE HISTORY

See Appendix A.

OTHER STATES' INFORMATION

Florida, Illinois, Massachusetts, Michigan, Minnesota, and *New York's* tax laws do not impose a similar income tax of which the proceeds fund a specific government program. The laws of these states were reviewed because their tax laws are similar to California's income tax laws.

FISCAL IMPACT

This bill would require the FTB to revise the tax forms, instructions, and booklets. As a result, this bill could impact the department's printing and processing costs for tax returns. The additional costs have not been determined at this time, but will be developed as the bill moves through the legislative process and an appropriation will be requested, if necessary.

ECONOMIC IMPACT

Revenue Estimate

This provision would result in the following revenue gains:

Estimated Revenue Impact of AB 1196: Provision 1 For Taxable Years Beginning On or After January 1, 2012 Enactment Assumed After June 30, 2011 ($ in Millions)			
	2011-12	2012-13	2013-14
Additional 0.7% Tax On Income Over $1M	+$490	+$800	+$850

This analysis does not account for changes in employment, personal income, or gross state product that could result from this provision.

POLICY CONCERNS

This provision would impose an additional 0.7 percent tax on personal taxable income in excess of $1,000,000 and would apply equally across filing statuses. The application of the increased tax rate regardless of filing status would create a "marriage penalty"[3] and encourage affected married individuals/registered domestic partners to file separately to reduce their overall tax burden. If the author intends to prevent this result, the author may wish to amend the language to equalize the tax treatment of married individuals/registered domestic partners filing separately and married individuals/registered domestic partners filing jointly.

[3] The "marriage penalty" refers to the higher tax liability of married two-worker couples, compared to their non-married counterparts. The "marriage penalty" was a consequence of the Revenue Act of 1948, when Congress abandoned treatment of the individual as the taxpayer unit and adopted the split-income plan of joint returns for married persons. (Pub. L. No. 471, Ch. 168, §§ 301-305, 62 Stat. 110, 114-16 (codified as amended in scattered sections of 26 U.S.C.)).

PROVISION 2-REFUNDABLE EARNED INCOME TAX CREDIT

ANALYSIS

FEDERAL/STATE LAW

Federal law allows eligible individuals a refundable EIC. A refundable credit allows for the excess of the credit over the taxpayer's tax liability to be refunded to the taxpayer. The credit is a percentage of the taxpayer's earned income and is phased out as income increases. The percentage varies, based on whether the taxpayer has qualifying children.

The federal credit for the 2010 taxable year is determined as follows:

An eligible individual With:	Earned Income	Completely Phased-Out @	Credit Rate (%)	Maximum Credit (for all file statuses)
1 qualifying child	$8,970	$35,535 ($40,545 if married filing jointly	34.00%	$3,050
2 or more qualifying children	$12,590	$40,363 ($45,873 if married filing jointly)	40.00%	$5,036
3 or more qualifying children	$14,165	$43,352 ($48,362 if married filing jointly)	45.00%	$5,666
No qualifying children	$5,973	$13,460 ($18,470 if married filing jointly	7.65%	$457

California does not provide an EIC. Existing state laws provide various tax credits designed to provide tax relief for taxpayers that incur certain expenses (e.g., child and dependent care credits), to influence business practices and decisions, or to achieve social goals. Credits are allowed against net tax based on a set order of priority as specified in the Revenue and Taxation Code.

Under state law, individuals with income below the filing thresholds are not required to file an income tax return because the standard deduction and personal exemption credit eliminate any tax liability. For 2010, these thresholds are $14,754 in gross income or $11,803 in adjusted gross income[4] (AGI) for single taxpayers and $29,508 in gross income or $23,607 in AGI for married filing joint taxpayers. These thresholds are increased based on the number of dependents claimed and are increased annually for inflation.

THIS PROVISION

This provision would provide a refundable state EIC equal to 15 percent of the version of the federal EIC (prior to its reduction by alternative minimum tax (AMT)) in effect as of January 1, 2011. The amount of state EIC would be reduced by state AMT, if applicable. Any state EIC credit in excess of the state tax liability would be credited against other amounts due, and the balance would be refunded to the taxpayer. The refunded portion of the state EIC would be provided for through continuous appropriations from the Earned Income Tax Credit Fund, established by this bill.

[4] For purposes of state income tax law, AGI is defined by cross-reference to the Internal Revenue Code (IRC) as gross income, which includes all income from whatever source derived, adjusted for certain allowable amounts, including IRA contributions, alimony paid, moving expenses, and Keogh account contributions.

This provision establishes a wait list for taxpayers if the refunds exceed the amount available in the Fund. The FTB would be required to notify taxpayers when they have been placed on the wait list.

This provision specifies that no credit shall be allowed to (1) any person who is a nonresident for any portion of the taxable year, or (2) any person who is married and files a separate return for the taxable year.

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

Many taxpayers eligible for the federal EIC have no California income tax return filing requirement. These nonfilers would be required to file a California income tax return to claim the proposed state EIC, which could impact the department's programs and costs.

Typically, refund returns are filed early in the filing season. If taxpayers claiming the California EIC file late in the filing season, after they receive their federal EIC, that behavior could have a major impact on the processing of returns and possibly cause delays in the issuance of refunds. The taxpayer error rate on the federal EIC and the fraud concerns cause the IRS to adjust many returns. Consequently, the correct federal EIC amount may be unknown until after the taxpayer has filed the state return, claimed the proposed California credit, and received a refund. The FTB could be required to issue an assessment to retrieve incorrect refunds and incur costs to do so.

Relying on the EIC under federal law may present implementation problems for Registered Domestic Partners (RDPs). RDPs are required to file California income tax returns using the rules applicable to married individuals. If the author's intent is to allow EIC for RDPs, a rule should be included in the bill to address the difference between federal and state law.

Historically, the department has had significant issues with refundable credits and fraud. These problems would be aggravated because if a refund is made that is later determined to be fraudulent, the refund commonly cannot be recovered. Striking the refundability provision from this credit would substantially reduce the department's concerns regarding fraud.

This provision bases the state EIC on how the federal EIC is calculated on January 1, 2011. If the federal EIC calculation changes after January 1, 2011, then the state EIC would be based on a formula that would no longer be used for the current federal income tax return. This could lead to taxpayer confusion. To reduce taxpayer confusion, the author may wish to amend the bill to eliminate the specifically dated version of the federal EIC that is used to calculate the state EIC.

LEGISLATIVE HISTORY

AB 21 (Jones, 2007/2008), similar to this provision, would have established a nonrefundable EIC equal to 5 percent of the federal EIC. AB 21 failed to pass out of the Assembly Appropriations Committee.

SB 224 (Cedillo, 2003/2004), similar to this provision, would have provided a refundable EIC equal to 15 percent of the federal EIC. SB 224 failed to pass out of the Senate Revenue & Taxation Committee.

AB 106 (Cedillo, 2002/2001), similar to this provision, would have provided a refundable EIC equal to 15 percent of the federal EIC. AB 106 failed to pass out of the Assembly Appropriations Committee.

AB 1854 (Cedillo, 1999/2000), similar to this provision, would have provided a refundable EIC equal to 15 percent of the federal EIC. AB 1854 failed to pass out of the Assembly Appropriations Committee.

AB 2466 (Wiggins, 1999/2000) would have provided a nonrefundable EIC in an amount equal to an unspecified percentage of the earned income credit allowed by federal law. This bill failed to pass out of the Assembly Revenue & Taxation Committee.

SB 1421 (Solis, 1999/2000), similar to this provision, would have provided a refundable EIC equal to 15 percent of the federal EIC. SB 1421 failed to pass out of the Senate Revenue & Taxation Committee.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York.* These states were selected due to their similarities to California's economy, business entity types, and tax laws.

Florida does not provide a tax credit comparable to the credit proposed by this bill.

Illinois allows taxpayers to claim a refundable credit equal to 5 percent of their federal EIC on their return.

Massachusetts allows taxpayers to claim a refundable credit equal to 15 percent of their federal EIC.

Michigan allows taxpayers to claim a refundable credit equal to 20 percent of their federal EIC.

Minnesota allows taxpayers to claim a Working Family Credit (WFC) if they also claimed the federal EIC. The WFC is based on either the federal earned income or the federal AGI depending on whichever amount is smaller.

New York allows taxpayers to claim a refundable credit equal to 30 percent of the federal EIC on their return for tax years beginning in 2003.

FISCAL IMPACT

This provision would require instructions and a calculation for the credit that would require a new form or worksheet to be developed. In addition, this provision would require that a wait list be created and established as well as the mailing of notices to taxpayers on the wait list.

As a result, this provision would impact the department's printing, processing, and mailing, costs for personal income tax returns. The additional costs will be developed as the implementation concerns are resolved and the bill moves through the legislative process. It is recommended that the bill be amended to include appropriation language that would provide funding to implement this bill. Lack of an appropriation would require the department to secure the funding through the normal budgetary process, which could delay implementation of this bill.

ECONOMIC IMPACT

<u>Revenue Estimate</u>

This provision would result in the following revenue losses:

This bill would result in the following revenue gains:

Estimated Revenue Impact of AB 1196: Provision 2 For Taxable Years Beginning On or After January 1, 2012 Enactment Assumed After June 30, 2011 ($ in Millions)			
	2011-12	2012-13	2013-14
Refundable Earned Income Credit	-$420	-$750	-$750

This analysis does not account for changes in employment, personal income, or gross state product that could result from this provision.

LEGAL IMPACT

This bill contains provisions that would target certain incentives to residents of California while denying the same incentives to nonresidents. The U.S. Supreme Court in *Lunding Et Ux. v. New York Appeals Tribunal et al.* (1998) 118 S. Ct. 766, found that denying a tax benefit to a nonresident taxpayer, while allowing such a benefit to resident taxpayers, was discriminatory and thus unconstitutional. Consequently, an EIC conditioned on full-year residency in California may be subject to constitutional challenge.

LEGISLATIVE STAFF CONTACT

Brian Werking
Legislative Analyst, FTB
(916) 845-5103
brian.werking@ftb.ca.gov

Patrice Gau-Johnson
Asst. Legislative Director, FTB
(916) 845-5521
patrice.gau-johnson@ftb.ca.gov

Appendix A
Legislative History

Bill Number	Action	Status
AB 1836 (Furutani, 2009/2010)	Would have temporarily increased the two highest PIT rates and the AMT rate.	Failed passage out of the first house.
SB 96 (Ducheny, 2009/2010)	Would have added four higher tax brackets with higher tax rates.	Failed passage out of the first house.
ABX3 3 (Evans, Stats. 2009, 3d. Ex. Sess. 2009/2010, Ch. 18)	Temporarily increased PIT and AMT rates.	Chaptered February 20, 2009.
AB 2897 (Hancock, 2007/2008)	Would have established two higher tax brackets with higher tax rates.	Failed passage out of the Assembly Revenue and Taxation Committee.
AB 6 (Chan, 2005/2006)	Would have established two higher tax brackets with higher tax rates and increased the AMT rate, giving a credit for the tax imposed by Proposition 63.	Failed passage out of the first house.
AB 1403 (Coto, 2005/2006)	Would have established two higher tax brackets with higher tax rates and increased the AMT rate.	Failed passage out of the Assembly Revenue and Taxation Committee.
AB 4 (Chan, 2003/2004)	Would have established two higher tax brackets with higher tax rates and increased the AMT rate.	Failed passage out of the first house.
Proposition 63 (Steinberg)	Imposed a 1 percent tax on taxable incomes over $1 million.	Approved by the voters in the November 2004 General Election.
SB 1255 (Burton, 2001,2002)	Would have established two higher tax brackets with higher tax rates and increased the AMT rate.	This bill was held in the Assembly Revenue and Taxation Committee.
SB 169 (Alquist, Stats.1991, Ch. 117)	Temporarily established two higher tax brackets with higher tax rates and increased the AMT rate.	Chaptered July 16, 1991.